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No. 83-598

In the Supreme Court of the United States

OCTOBER TERM, 1983

JOSEPH P. MAZZOLA, ET AL., PETITIONERS

v.

RAYMOND J. DONOVAN, SECRETARY OF LABOR,
UNITED STATES DEPARTMENT OF LABOR

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the court of appeals correctly applied the "prudent person" rule, in determining that petitioners, trustees of a pension fund, breached their fiduciary duties under Section 404(a)(1)(B) of the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. 1104(a)(1)(B).

2. Whether ERISA's prohibited transaction provision, 29 U.S.C. 1106(b)(2), establishes a per se prohibition against loans between a pension fund and another fund where the trustees of both funds are identical, but the participants and beneficiaries are not.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A33) is reported at 716 F.2d 1226. The opinion and judgment of the district court (Pet. App. A34-A89, A90-A98) are unreported.

JURISDICTION

The judgment of the court of appeals was entered on August 23, 1983. The petition for a writ of certiorari was filed on October 11, 1983. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioners are certain present and former members of the Board of Trustees of the Pension Fund of

Local Union 38 of the United Association of Journeymen and Apprentices of the Plumbing and Pipefitting Industry (Pet. App. A2). The Pension Fund is an "employee benefit plan" within the meaning of the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. 1002(3), and petitioners, as trustees of the fund, are "fiduciaries" with respect to it pursuant to 29 U.S.C. 1002(21)(A) (Pet. App. A2-A3). From January 1, 1975 (the effective date of ERISA's fiduciary provisions (see 29 U.S.C. 1114)), through November 30, 1978, petitioners simultaneously served as trustees of Local Union 38's Convalescent Fund; after November 30, 1978, they acted as an "Advisory Committee" to a sole trustee of the Convalescent Fund (Pet. App. A3). The participants in the Pension Fund and the Convalescent Fund are not identical; thus, some participants in and contributors to the Pension Fund have not been participants in or contributors to the Convalescent Fund (*id.* at A3, A25, A36-A37).

The Convalescent Fund owns a piece of property in Clear Lake, California, on which it operates a summer camp, a low-cost retirement housing project for participants in the Convalescent Fund, and the Konocti Harbor Inn, a resort hotel that offers rooms at discount rates to Convalescent Fund participants under certain circumstances (Pet. App. A3, A37). For years, the Convalescent Fund's Clear Lake operations have lost substantial sums of money; for example, the Konocti Harbor Inn has lost more than $1 million annually in every year since 1973 (*id.* at A39-A40).

In December 1975, petitioners, in their capacity as trustees of the Convalescent Fund, sought from themselves, in their capacity as trustees of the Pension Fund, a $1.5 million loan from Pension Fund assets (Pet. App. A12). Acting as trustees of the Pension Fund, petitioners granted the loan at 8.5% interest (*id.* at A14, A39). At the time, the interest rate on long-

term commercial mortgages ranged from 9.75% to 10% (*id.* at A14, A43). The Convalescent Fund was in poor financial condition when the loan was granted; it had suffered substantial operating losses and had been unable to make regular payments on previous loans it had obtained from the Pension Fund and from a bank (*id.* at A12, A39-A41). The security given for the loan consisted of the unimproved portion of the Convalescent Fund's Clear Lake property, which did not contain the resort facilities, and which was subject to prior bank loans and had already been pledged as security for an earlier $5.5 million loan from the Pension Fund to the Convalescent Fund (*id.* at A12-A13, A41-A43). Petitioners did not ascertain the value of the property pledged as security for the $1.5 million loan, nor did they determine to what extent the Pension Fund's interest in that property was subordinate to other security interests (*ibid.*).

In October 1976, petitioners, in their capacity as trustees of the Convalescent Fund, sought from the Pension Fund a six-month moratorium on repayment of all outstanding loans; in their capacity as trustees of the Pension Fund, petitioners granted the moratorium without requiring additional security or consideration to protect the Pension Fund (Pet. App. A44-A45). In 1978 and 1979, petitioners granted the Convalescent Fund two extensions to repay a $500,000 loan made by the Pension Fund in December 1974 and due November 1, 1978. The extensions were granted without altering the terms of the loan or requiring additional security. *Id.* at A4, A46-A47.

In June 1979, petitioners loaned $650,000 of Pension Fund assets to S & F Spas, a limited partnership, for the purpose of assisting S & F in the development and promotion of a health spa facility in Santa Rosa, California (Pet. App. A6, A49). Previously, petitioners had approved a $2.25 million loan to S & F (*id.* at A6,

A48-A49). Petitioners approved the $650,000 loan without obtaining a reliable, up-to-date feasibility study, cost estimates, certified financial statements, or market analysis. They failed to monitor S & F's use of the proceeds from the $2.25 million or $650,000 loans. *Id.* at A51. In addition, petitioners failed to obtain adequate security for the $650,000 loan (*id.* at A51-A57).

In April 1977, petitioners commissioned Dr. Ernest Schwartz, a friend of one petitioner and personal physician for another, to prepare a feasibility study to determine how the Convalescent Fund could best use the Konocti Harbor Inn property (Pet. App. A5, A16). Petitioners paid Dr. Schwartz $250,000 for the feasibility study (*ibid.*). A professionally prepared feasibility study of acceptable quality, covering the same subject areas as Dr. Schwartz's study, would have cost no more than $100,000 (*id.* at A67). Petitioners did not inquire into Dr. Schwartz's qualifications to prepare the study, did not solicit bids or interview other persons to perform the study, did not seek information concerning how much another person would have charged for the study, did not negotiate the amount of Dr. Schwartz's fee, and did not consult experts concerning Dr. Schwartz's proposed methodology (*id.* at A16-A17, A64-A66). Dr. Schwartz had never before prepared a written feasibility study and had never specialized in advice on or analysis of recreational-resort property or any other specific type of real estate (*id.* at A65-A66). He kept no time records and did no follow-up work after his report was completed (*id.* at A19, A65-A66). Contrary to prevailing practice, petitioners paid Dr. Schwartz his full fee before the study was completed (*id.* at A20, A66-A67). The study failed to meet professional standards of acceptability in several respects, and approximately $50,000 to $100,000 worth of corrective work would have been required to upgrade the

study into a professionally competent document (*id.* at A19, A67-A69).

2. In January 1979, the Secretary of Labor filed suit in the United States District Court for the Northern District of California, alleging that in authorizing the foregoing investments petitioners had breached various fiduciary duties imposed by ERISA. Based on facts established in an extensive pre-trial stipulation and evidence introduced at trial, the district court held that petitioners had violated several of their fiduciary duties under ERISA and ordered appropriate relief, including restitution of losses to the Pension Fund, posting of an indemnity bond, and appointment of an investment manager (Pet. App. A34-A98).

The district court found that in making the $1.5 million loan to the Convalescent Fund, granting a moratorium on its repayment, and granting unconditional extensions for the repayment of other loans, petitioners had failed to act in accordance with prevailing industry standards exercised by competent real estate lenders in making, pricing, and managing real estate-secured loans (Pet. App. A42-A43). Accordingly, the court held that petitioners had violated 29 U.S.C. 1104(a)(1)(B), which requires fiduciaries to discharge their duties "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."

The district court also found that petitioners had acted on both sides of the loan transactions and "have consistently transacted business with and for the Convalescent Fund at all relevant times for the purpose of aiding the Convalescent Fund at the expense of the Pension Fund" (Pet. App. A75). This conduct, the court ruled, violated 29 U.S.C. 1104(a)(1)(A), which requires trustees to discharge their duties for the exclusive pur-

pose of benefitting participants in a covered plan and defraying reasonable administrative expenses (Pet. App. A75-A76). The court further held that petitioners had committed a per se violation of the rule of undivided loyalty, embodied in 29 U.S.C. 1106(b)(2), by acting on both sides of the loan transactions between the Convalescent Fund and the Pension Fund (Pet. App. A82-A83).

The district court additionally found that a reasonably competent lender in petitioners' position would not have made the "unreasonably risky" $650,000 loan to S & F and that petitioners had failed "to follow reasonable procedures for underwriting the loan" (Pet. App. A76). Therefore, the court held that in authorizing the loan to S & F, petitioners had violated 29 U.S.C. 1104(a)(1)(B) (Pet. App. A76). The court also held (*id.* at A80-A82) that the $1.5 million and $650,000 loans violated the statutory diversification requirement (29 U.S.C. 1104(a)(1)(C)), which directs fiduciaries to diversify investments so as to minimize the risk of large losses unless it is clearly prudent not to do so.

Finally, the district court found that petitioners had spent an unreasonable amount of money, without adequate investigation, for the services of Dr. Schwartz, and held that this expenditure violated both 29 U.S.C. 1104(a)(1)(A) and (B) (Pet. App. A83-A84).

3. The court of appeals affirmed the district court's decision and order in its entirety, upholding all of the foregoing factual findings as not clearly erroneous (Pet. App. A1-A33). The court held, inter alia, that the district court properly applied ERISA's "prudent person" test in concluding that petitioners had breached their fiduciary duties under 29 U.S.C. 1104(a)(1)(B), and that petitioners had committed a per se violation of 29 U.S.C. 1106(b)(2) by participating in a loan transaction between two trust funds (the Pension Fund and the Convalescent Fund) whose trustees are identical, but

whose participants and beneficiaries are not (Pet. App. A12, A25-A28).

ARGUMENT

Petitioners do not contend that the decision below conflicts with any decision of this Court or of any other court. The court of appeals' decision, moreover, is correct. Accordingly, further review is unwarranted.

1. Petitioners contend (Pet. 8-9) that even though they acted imprudently in their investment decisions, they may not be found to have violated their fiduciary responsibilities under ERISA absent evidence of "dereliction of duty, gross negligence, or bad faith." Petitioners cite no authority for this proposition, and their argument is clearly without merit.

ERISA requires fiduciaries to discharge their duties "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." 29 U.S.C. 1104(a)(1)(B). As the court of appeals held (Pet. App. A10-A12), this explicit statutory language, as well as the legislative history of ERISA, establishes that the standard of care to which petitioners are subject is the "prudent person" test, as developed in the common law of trusts and "bearing in mind the special nature and purposes of employee benefit plans." S. Rep. 93-127, 93d Cong., 1st Sess. 29 (1973); H.R. Rep. 93-1280, 93d Cong., 2d Ses. 302 (1974).[1] Under the common law, trustees making

[1] The courts that have discussed the question have noted that 29 U.S.C. 1104(a)(1)(B) adopts the common law prudent person rule. See, *e.g.*, *Eaves* v. *Penn*, 587 F.2d 453, 457 (10th Cir. 1978); *Morrissey* v. *Curran*, 567 F.2d 546, 547-549 & n.8 (2d Cir. 1977). Cf. *NLRB* v. *Amax Coal Co.*, 453 U.S. 322, 329 (1981) ("Where Congress uses terms that have accumulated settled meaning under either equity or the common law, a court

investment decisions are required to use a reasonable degree of care and skill in selecting investments and must "exercise the caution which a prudent man would exercise where a primary consideration is the preservation of the funds invested." 3 A. Scott, *The Law of Trusts* § 227, at 1806 (3d ed. 1967). Among other things, the trustees' obligations include the duty to investigate independently and to evaluate thoroughly the risks and merits of particular investments in light of available alternatives (see, *e.g.*, *Donovan* v. *Bierwirth*, 680 F.2d 263, 271, 273-276 (2d Cir. 1982), cert. denied, No. 82-422 (Dec. 6, 1982); *Marshall* v. *Glass/Metal Association & Glaziers & Glassworkers Pension Plan*, 507 F. Supp. 378, 384 (D. Hawaii 1980)), and the duty to structure those investments in a manner that similarly situated persons in the relevant field would consider appropriate (*id.* at 384).[2]

The court of appeals correctly held (Pet. App. A12) that the district court properly applied the prudent person test, as to each transaction involved in this case, by considering whether petitioners employed accepted methods to investigate the merits of each investment and whether they structured the investments prudently. Absent "a very obvious and exceptional showing of error," which is clearly not present in this case, the

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must infer, unless the statute otherwise dictates, that Congress meant to incorporate the established meaning of these terms.").

[2] Petitioners' assertion (Pet. 10) that the court of appeals "rejected the notion that ERISA leaves to the trustee any ambit of discretion or business judgment such as the common law accorded to trustees" is baseless. The court correctly recognized (Pet. App. A11 n.4) that, as the cited portion of *Scott on Trusts* explains, the prudent person rule applied to trustees' investment decisions at common law, and the court applied that standard to petitioners' conduct. Moreover, petitioners do not explain how the application of an objective standard of "business judgment" to the established facts of this case would change the result reached by the courts below.

concurrent factual findings of the court of appeals and the district court, determining that petitioners failed to adhere to the applicable standard of care, do not warrant further review. See *Graver Tank & Mfg. Co.* v. *Linde Air Products Co.*, 336 U.S. 271, 275 (1949).[3]

2. Petitioners' suggestion (Pet. 10) that the district court erred in holding that petitioners failed to diversify investments so as to minimize the risk of large losses, in violation of 29 U.S.C. 1104(a)(1)(C), also does not merit further review. First, petitioners did not raise this argument in the court of appeals, the court of appeals did not consider the question, and petitioners advance no compelling reasons for this Court to address the issue. See, *e.g.*, *Adickes* v. *S.H. Kress & Co.*, 398 U.S. 144, 147 n.2 (1970), and cases cited therein. Second, this fact-bound issue, like the others petitioners present, is plainly not appropriate for review on certiorari. *Berenyi* v. *Immigration Director*, 385 U.S. 630 (1967). In any case, uncontradicted expert testimony established that the investments were inadequately diversified (Pet. App. A57-A64).

3. Petitioners contend (Pet. 12) that the Third Circuit's decision in *Cutaiar* v. *Marshall*, 590 F.2d 523 (1979), was "wrongly decided" and should not have been followed by the courts below. In *Cutaiar*, the court held that a per se violation of the rule of undivided loyalty contained in 29 U.S.C. 1106(b)(2) is estab-

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[3] It would be inappropriate, therefore, for this Court to review petitioners' suggestions (Pet. 9-10) that they did not act imprudently in loaning $1.5 million to the financially troubled Convalescent Fund or $650,000 to S & F Spas, or that they properly paid $250,000 for Dr. Schwartz's "feasibility study." In any event, petitioners' attempt (Pet. 9, 10) to justify the reasonableness of investing in the Convalescent Fund and S & F Spas on the ground that the investments generated both employment for union members and employer contributions to the Pension Fund is not supported by the record or by any findings of the courts below.

lished where there is a transaction between two funds whose trustees are identical, but whose participants and beneficiaries are not. *Cutaiar*, 590 F.2d at 529. But that holding does not require review in this case, because petitioners also violated their duties under 29 U.S.C. 1104(a)(1)(A) and (B). As the court of appeals held (Pet. App. A25), those violations alone justify the relief ordered by the district court.

In any event, it is clear that the rule of per se liability established in *Cutaiar* and followed by the courts below is correct. The statute provides that a fiduciary shall not "act in any transaction involving the plan on behalf of a party * * * whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries." 29 U.S.C. 1106(b)(2). As the court noted in *Cutaiar*, 590 F.2d at 530 (emphasis in original), "[f]iduciaries acting on both sides of a loan transaction cannot negotiate the *best* terms for either plan"; thus, "[e]ach plan must be represented by trustees who are free to exert the maximum economic power manifested by their fund whenever they are negotiating a commercial transaction."

There is no merit, therefore, to petitioners' argument (Pet. 11) that they should have been allowed to present evidence on the "substantial identity" of the participants and beneficiaries of the two funds. As the court recognized in *Cutaiar*, 590 F.2d at 530, "[i]f there is a single member who participates in only one of the plans, his plan must be administered without regard for the interests of any other plan." This requirement of undivided loyalty leaves no room for petitioners' contention that the trustees may properly balance the advantages and disadvantages of a particular transaction to each fund to accomplish an objective "which transcends the interest of a single fund" (Pet. 11).[4]

[4] Contrary to petitioners' contention (Pet. 12), the *Cutaiar* rule does not prohibit interfund transactions or require each

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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fund to have a separate set of trustees. The trustees may seek an exemption, under 29 U.S.C. 1108(a), from ERISA's prohibited transaction provisions, or they may appoint an independent investment manager for one of the funds to represent that fund in all interfund transactions.